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ABSTRACT

In this booklet, one of a series intended to apply economic principles to major social and political issues of the day, an analogy is drawn between the dire predictions once made about the energy crisis and those now being made about a budget crisis. Concerns about the deficit have centered on inflation, interest rates, and growth of the economy. This essay considers the relationship between those factors and the federal budget deficit. The topics covered include: (1) how the deficit got so large; (2) how a deficit can be financed; (3) the relationship between deficits and inflation; (4) the relationship between deficits and high interest rates, including interest rates and debt financing, interest rates and monetizing the deficit, and interest rates and tax financing; (5) the question of whether a deficit stimulates growth; (6) the question of whether a deficit retards growth; and (7) whether a balanced budget amendment is a wonder drug for the 1980's. Brief sections deal with bracket creep, monetizing the deficit, money and prices, deficits and inflation, monetarists and Keynesians, a simplified example of the relationship between the deficit and employment, and the historical roots of fiscal responsibility. (IS)

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"The practice of [deficit] funding has enfeebled every state which has adopted it."

Adam Smith in
***The Wealth of Nations*, 1776**

We Americans lived through "the energy crisis" of the 1970's only to be confronted with "the deficit crisis" in the 1980's. In the 1970's, we heard that resource shortages were to end the prosperity we had come to expect. In the 1980's, some of the same dire predictions were being made, only this time the predictions of decline were based on the size of the deficit rather than on the exhaustion of an essential resource. For example, in 1984 *Business Week* devoted some 50 pages to the federal deficit, employing ominous leads like[1]

> **[The deficit] threatens to reignite inflation and prevent long term prosperity.**

We survived the energy crisis. Can we expect to survive the deficit crisis? More to the point, what exactly is the deficit crisis? What kind of problems result from large deficits and what can be done about them?

When we watched the evening news or read the newspaper during the mid-1980's, it almost seemed that the deficit was a new issue . . . that the deficit was the issue of the 80's. While the media attention for the deficit is new, the issue itself has been discussed as long as the discipline of economics has existed. Our lead quotation indicates that Adam Smith was concerned with government deficit spending. Throughout the years, economists and policymakers have been concerned with the size of the deficit. Even John Maynard Keynes, the economist most people point to as the originator of deficit spending, expressed concern about large budget deficits:

> **". . . the policy may have adverse reactions on investment in other directions . . . [it] may have the effect of increasing the rate of interest and so retarding investment . . ."**
> ***The General Theory of Employment, Interest and Money***

Indeed, even the balanced budget amendment is not a new idea. As we will show, the idea behind the current impetus for a balanced budget was discussed as early as the 19th century.

Notwithstanding the discussions of the deficits in the past, it is clear that in the 1980's the citizens of the United States became very concerned about the federal deficit. In particular, Americans became concerned about the impact of the deficit on

- Inflation

- The Interest Rate
- Growth of the Economy

When the deficit became public problem #1, the media devoted a great deal of air time and print discussing the new crisis confronting America. However, it is our opinion that much of what we heard on the evening news broadcasts and read in the newspapers and magazines did not make very good *economic* sense. While the deficit crisis may have made good copy, it is our opinion that the discussions about the deficit and, in particular, the solutions provided were much too simplistic. For example, many of the reports and articles asserted that taxes would *have* to be raised . . . and quickly. While raising taxes would solve the deficit crisis, is it the only solution? Is it the best solution? Furthermore, it was reported that the public opinion polls indicated that more than 70% of Americans favored a balanced budget. Again a balanced budget would eliminate the deficit; but, is a balanced budget a wonder drug for the 80's?

It is questions like the preceding that we want to address in this monograph. At the outset, we want to make it clear that it is not our purpose to write a definitive statement about budget deficits. Our objective is much more limited: We want to provide the necessary information for you to be able to form your own opinions about how the "deficit crisis" should be handled.

The topic of budget deficits—or the federal budget in general—is extremely complicated. In order to make this inherently complex issue as simple as possible, we have presented our discussion as answers to some of the basic questions it appears many Americans are asking. Interspersed in the monograph we have provided some "Asides" in which we provide a simplified discussion of some of the more technical issues.

How Did the Deficit Get So Large?

A federal deficit, like a deficit for an individual household, occurs when more is spent than is taken in. That is, a federal deficit exists when government spending exceeds government revenues.

It is all too easy to talk about government "spending" and government "revenues." Exactly where does the federal government get the money it spends and on what does it spend the money? To provide some idea about the sources of revenue and uses of funds for the federal government, Exhibit 1 depicts graphically the shares of the major categories of revenues and expenditures for the United States government. (The figures used are based on data for 1982).

Looking at Exhibit 1, one of the major problems becomes evident: If the deficit is to be eliminated by balancing the budget, revenues would have to be increased or expenditures would have to be reduced. If we were to increase revenues, which source will we use? Do we want to increase individual income taxes? Corporation income taxes? On the other side, if we wish to reduce expenditures, which categories will we cut? Shall we cut defense spending? Shall we cut governmental transfer payments, in which social security payments, unemployment compensation, and assistance to the poor and needy are the primary components? It is in the case of expenditures that the dilemma is most apparent. Only a very small portion of the expenditure budget is what might be called discretionary spending. Reducing the expenditures would require that a member of congress vote for a cut that may not be received very well by his or her constituents.

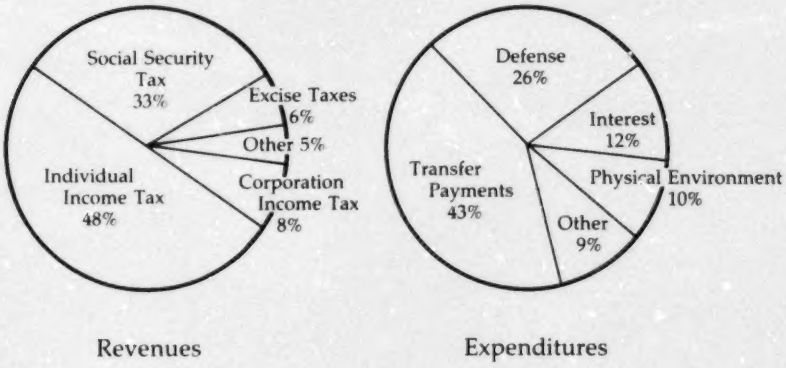

Exhibit 1
Federal Revenues and Expenditures

In 1984, the U.S. was faced with a budget deficit in excess of $150 billion. Not only was this figure high in absolute terms, it was also high as a percent of GNP. Indeed, budget deficits had been increasing both in dollar terms and as a percent of GNP for more than a decade. Exhibit 2 summarizes the size of budget deficits as a percent of GNP since 1960.

7

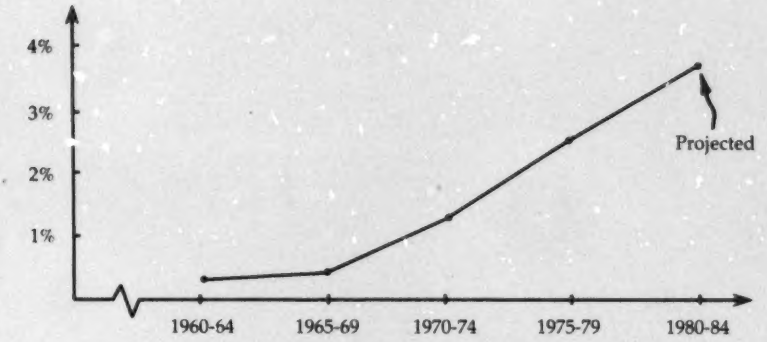

Exhibit 2
Budget Deficits as a Percent of GNP

Why has the federal deficit grown so large in recent years? The answer to that question is simple: Federal expenditures were growing more rapidly than was the tax base (i.e., level of national income) necessary to support them. Let's put this relation another way. During the 1970's, real income in the United States—that is, income adjusted for the effects of inflation—was growing at a rate of about 2½ percent annually. However, over the same period, real federal expenditures were growing at an annual rate of approximately 4 percent annually. Since the growth in real income lagged behind that of federal expenditures, tax revenues lagged behind spending. (And this was so, even though tax rates were increased via inflation pushing taxpayers into higher and higher tax brackets, a point we will look at in an aside to follow.) To illustrate the disparity between the rates of growth in national income and federal expenditures, we have in Exhibit 3 plotted the growth rates in these two.

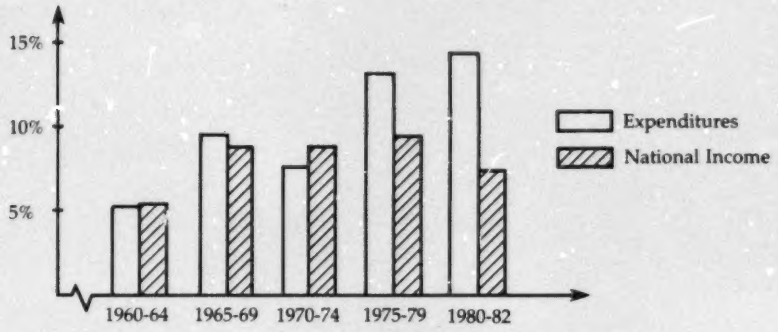

Exhibit 3
Growth Rates in Federal Spending and National Income

ASIDE—Bracket Creep

In the preceding, we indicated that inflation can increase the tax rate paid by an individual household. This is because the personal income tax is a progressive tax. The term progressive means that as income increases, the tax rates applied are progressively higher and higher.

Hence, if income rises due only to inflation, the taxpayer ends up paying a higher percentage of income in taxes. Even though the household is no better off in terms of what its income would buy (e.g., if wages and prices both rose by 10%), the increase in income would push the household into higher and higher tax brackets. Therefore, the household would end up owing the government a higher share of its income. Inflation causes individuals to *creep* into higher and higher tax brackets. The result is that the typical household has less real spendable income.

How Can a Deficit be Financed?

When we as individual households have a deficit in our budgets, we must somehow handle that deficit. Obviously, we could eliminate the deficit by reducing expenditures. However, if we can not or do not wish to reduce expenditures, we must somehow cover the shortfall—we must finance the deficit. In the case of an individual household, there are two ways in which we can finance the deficit:

- Increase Income—In the simplest case, this may mean that another family member accepts employment or that one member takes on an extra job.
- Borrow—The other way in which a household's deficit could be financed is through borrowing. (Note that, when the household borrows money from a bank or S&L, that household is essentially selling a bond. The bank accepts a piece of paper from the household which is a promise to pay some amount of money at a future date. That piece of paper—the promissory note—is nothing more than a bond issued by the household.)

If a government is faced with a deficit and is unwilling or unable to reduce expenditures, it has the same methods available with which it can finance the deficit: It can increase its income by increasing taxes. Or it can borrow money by selling bonds—in the case of the U.S. government, Treasury Bonds and Treasury Bills.

However, a federal government has an additional method of financing a deficit that is not available to an individual household: a federal government has a printing press and it can finance a deficit by creating more money and using the money to cover the deficit. Hence, the federal government has three methods by which it might *finance* the deficit:

(1) Increase Government Revenues by Increasing Taxes

(2) Borrow Funds by Selling Treasury Bond and Bills

(3) Increase the Money Supply—This policy is commonly referred to as "monetizing the deficit"

ASIDE—Monetizing the Deficit

When a deficit is monetized, the money supply would be increased to finance the deficit. It might be useful to be more precise about the way in which money is actually created.

The process begins in exactly the same way as if the deficit were to be financed by borrowing—the Treasury will issue new bonds. However, instead of selling these bonds to the public as would be the case if the deficit is to be financed via borrowing, the bonds would be sold to (purchased by) the Federal Reserve Bank. The Federal Reserve Bank pays for the bonds by *creating* a new demand deposit—checking account—from which the federal government can write checks to pay for its expenditures.

When the federal government uses the newly created demand deposit to purchase goods and services or to make a transfer payment (e.g., a social security payment), the recipient of the payment deposits the check drawn on the account of the U.S. government in his or her commercial bank. The individual (or firm) receiving the government's check has an increase in his or her deposits; simultaneously, the Federal Reserve Bank owes the commercial bank holding the deposit the amount of the check. This indebtedness of the Fed to the commercial bank is eliminated via a bookkeeping entry. Commerical banks are required to maintain reserves on deposit with the Federal Reserve System. (The amount of reserves required is determined by the amount of demand deposits of the commercial bank.) To clear the check, the Fed increases the commercial bank's reserves by the amount of the check.

The increase in the reserves held by this bank and by other commercial banks makes it possible for them to increase the amount of loans they have outstanding. As the commercial banks lend out their *excess* reserves—reserves in excess of those required by the Federal Reserve System—the money supply grows. Hence, by borrowing from the Federal Reserve System rather than the public, the money supply is increased.[2]

Do Deficits Cause Inflation?

Many observers have argued that deficits are the root cause of inflation in the United States. Indeed, some proponents of a balanced budget amendment have gone so far as to argue that elimination of deficits will get rid of inflationary pressure.

It is true that there exists a strong *correlation* between budget deficits and inflation. This correlation is demonstrated in Exhibit 4.

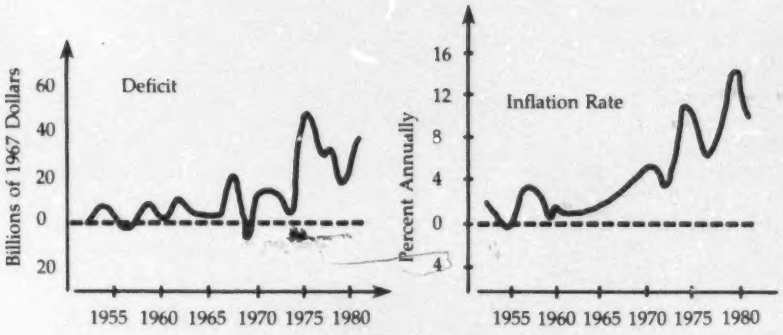

Exhibit 4
Deficits and Inflation

However, correlation does not imply causality. The fact that inflation and deficits have existed together does not mean that one has definitely caused the other. Indeed, there exists considerable dispute about the relation between inflation and deficits.

Currently, most experts believe that the tie between deficits and inflation exists in the method used to finance a deficit. The preponderance of opinion is that, if the deficit is financed by increasing the money supply, the result will be an inflation. That is, if the rate of growth of the money supply is substantially increased to finance increased government spending, prices will have to rise.

ASIDE—Money and Prices

The argument that increases in the money supply will lead to increases in the price level is based on what is often called the monetarist position. In its simplest form, this proposition is founded on an accounting identity, called the equation of exchange:

$$MV = PQ$$

In this, M is the money supply and V is the number of times each dollar changes hands in a year (the velocity of money); so, MV tells us the amount of money *spent* on final output in the economy. Likewise, P is the price level and Q is the physical output of goods and services in the economy; so, PQ is the amount of money *received* for final output. The two must always be equal.

If V and Q are relatively stable, it follows that increases in the money supply (M) will necessarily lead to increases in the price level (P). Hence, the monetarist position is that increases in the money supply (or increases in the rate of growth in the money supply) will lead to increases in the rate of inflation.

If, on the other hand, the deficit is financed by selling bonds to the public, the rate of growth of the money supply need not be increased and inflationary pressure will not be generated. This is particularly true if the deficit occurs during a recession.

This posited relation between inflation and deficit monetization would suggest that we look at recent experience to determine the extent to which recent deficits have been monetized. Exhibit 5 provides data on the percent of the deficit that has been financed by expansionary monetary policy in the period 1970-1981. The evidence presented in this table suggests that recent deficits have been financed more by borrowing than by the creation of new money.

Exhibit 5

Percent of the Deficit Financed by Increasing the Money Supply	
1970-74	21.8%
1975-78	11.7%
1979-81	3.9%

ASIDE—Deficits and Inflation

In the preceding, we have tried to provide what might be viewed as the majority report on the tie between deficits and inflation. However, there exist other opinions concerning this issue. No unanimity prevails.

As case in point, Gerald Dwyer has argued that deficits do not cause inflation. He argues that "there were large deficits from 1952 through 1981, but these appear to have been a consequence of inflation and not an important causal element in inflation over that period." Hence, his argument is that inflation has increased the cost of government more than it has increased government income and has therefore generated deficits, not the reverse.[3]

Do Large Deficits Lead to High Interest Rates?

It is this question that has received the most attention on Wall Street and in the popular press. The opinion most normally heard is that somehow large budget deficits lead to rising interest rates and that the result of the high interest rates is to "crowd out" private investment spending.

However, when one looks at the historical evidence, the linkage between deficits and interest rates is quite loose. As is indicated in Exhibit 6, the correlation between large budget deficits and high interest rates is low.

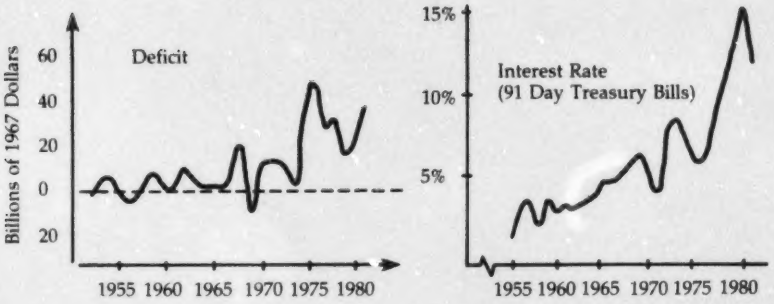

Exhibit 6
Deficits and Interest Rates

In the post World War II period, large budget deficits (as a percent of GNP) were incurred during 1958, 1967-68, 1971-72, and 1975-76. However, interest rates did not rise sharply during these periods. In fact, looking at the periods 1971-72 and 1975-76, interest rates were declining.

However, this simple figure does not tell the whole story. Some additional investigation is required. To examine this in greater depth, the impacts on the interest rate of different ways of financing the deficit must be considered.

Interest Rates and Debt Financing

Whether or not a deficit financed by borrowing from the public is expected to increase the interest rate substantially depends on the economic conditions that prevail at the time. We have already noted that, if the deficit occurs during a period of recession, the government can borrow large sums without substantially increasing the interest rate. The rationale behind this argument is that private investment demand is weak during a recession. Therefore, the government can borrow a large amount without competing with private demand for loanable funds. In this case, there is no upward pressure on interest rates. However, if the deficit occurs when the economy is fully employed, increased government borrowing in addition to the normal credit demands of firms and individuals would be expected to increase the price of loanable funds—the interest rate.

A more precise way of putting this is to say that the impact of debt financed deficits on interest rates depends on whether the deficit is permanent—a structural deficit—or whether it is the result of the business cycle and will disappear with economic recovery. In the latter case, economic recovery is expected to narrow a deficit as tax receipts rise faster than expenditures—e.g., in the recovery of 1975, the deficit fell from 4.2% to 2.1% of GNP. In such an instance, fears that federal borrowing will drive up interest rates may be unfounded. However, if the deficit is permanently embedded in the structure of taxes and spending, recovery will have no substantial lessening effect on the deficit, and there is every reason to expect the expanded federal borrowing to place upward pressure on interest rates.

Interest Rates and Monetizing the Deficit

Economists speak of interest rates as having a "real" component to which is added a premium for expected inflation. If inflation is expected to be higher in future periods, the interest rate charged by lenders for mortgages or purchases of new equipment will rise.

In the preceding section, it was noted that monetizing the deficit is expected to lead to increases in the rate of inflation in future years.

Therefore, if monetizing the deficit—financing the deficit by creating new money—leads to expectations of future inflation, the interest rate will necessarily rise.

In this scenario, high interest rates are indirectly induced by deficits. In this sense, deficits would indeed "cause" high interest rates, but only if they give rise to inflationary monetary policy.

In this view, the deficit would not immediately lead to increases in the rate of interest. Instead, the interest rate would rise only after the money supply had been expanded significantly and expectations of future inflation implanted. Looking again at Exhibit 6, the data are consistent with this explanation. Look particularly at 1969, 1973, and 1978 when interest rates did eventually rise some 12 to 24 months after the large budget deficits.

Interest Rates and Tax Financing

In the popular press, discussion of the crowding out that can occur from a deficit has centered on the concept of the demand for loanable funds. That is, the argument presented is that, if the government tries to borrow substantial sums, the increase in the demand for funds will increase the interest rate and crowd out private capital formation. As we have noted above, a deficit financed by increasing the money supply can also lead to increased interest rates and crowding out.

The impression left by the popular press is that by financing the deficit with a tax increase—in essence, eliminating the deficit in an accounting sense—there would be no crowding out of investment. The impression is left that a tax increase would *solve* the problem.

The point is, however, that an increase in taxes to finance a large deficit would also reduce private investment. Were the government to increase taxes by $150-200 billion to eliminate the deficit, we could expect private investment to decline.

An increase in taxes would have an effect on both the supply of and demand for loanable funds. (Remember that debt financing of the deficit is expected to impact only on the demand for loanable funds.) On the supply side, an increase in the income tax would raise the cost of saving; so, there would be less saving available for investors to borrow from for new capital projects. With this reduction in the supply of loanable funds, private investment would of necessity be "crowded out." The difference is that the crowding out occurs because of a reduction in the amount of funds available for investment projects.

On the demand side, an increase in taxes would reduce the after-tax rate of return for investment projects. That is, if taxes were increased, the net profitability of an investment would be reduced by the amount of the increase in taxes. And, if the rate of return earned declined, the demand for investment would also decline.

The upshot is then that an increase in taxes would be expected to reduce private investment. With an increase in taxes, both the supply of and demand for loanable funds would decline. The result of these shifts would be a lower equilibrium level of investment. While this is not the result of "crowding out" in the sense that it has been portrayed in the media, the net effect is the same.

ASIDE—Monetarists and Keynesians

Much of our analysis has to this point been based on what is called the monetarist position, for which Milton Friedman is the leading spokesman. However, even within this group, some disagreement exists. Friedman tends to downplay the impact of taxes on saving and stresses the conclusion that a deficit raises the interest rate, while a surplus—particularly a surplus gained by a reduction in government expenditures—would lower the interest rate. For example, Friedman observed the imposition of the income tax surcharge in the 1960s, and wrote "It was no surprise to those of us who stress money that enactment of the surtax was followed by a decline in interest rates."[4]

However, Friedman and the Keynesians would agree that a substantial tax increase accompanied by a contraction of the money supply will generate a recession and will *in effect* crowd out private sector investments. Hence, while the analysis we have provided above is essentially from a monetarist perspective, it represents what might be called a majority report of the nation's economists.

Let us take a moment to summarize our discussion of the impact of deficits on the interest rate. In the preceding, we have indicated that

(1) if a deficit is financed by borrowing from private firms and individuals, the increased demand for loanable funds will be expected to increase the interest rate and crowd out private investment,

(2) if a deficit is financed by increasing the money supply, expectations of future inflation can be formed causing the interest rate to rise and crowding out private investment, and

(3) if a deficit is financed (eliminated) by raising taxes, the decrease in the supply of and demand for loanable funds will be expected to reduce (crowd out) private investment.

All three methods of financing the deficit would be expected to reduce private investment.

Hence, it isn't the deficit that crowds out private investment. It is the size of government spending that is the culprit. If government spending as a percent of GNP rises, private investment will be crowded out. And this is true regardless of the method used to finance the deficit.

Does a Deficit Stimulate Growth?

For those who support deficit spending, the basic idea is that a deficit can stimulate demand in a recessionary period. As proposed by Keynes, if the economy is operating below full employment, increased government spending could be used to increase aggregate demand, thereby increasing GNP. Hence, the support for deficit spending is predicated on the capacity of a deficit to induce growth in the economy.

ASIDE—A Simplified Example

To illustrate the manner in which a government deficit is expected to increase income and employment, let's use a very simplified example. Consider an economy that is in equilibrium—i.e., aggregate demand is equal to aggregate supply—but is operating at less than full employment. For simplicity, let's assume that the individuals in this economy will spend 75% of any increases in income on consumption goods. (In the jargon of economics, we have assumed that the marginal propensity to consume in this economy is 0.75.)

Now, let someone—the mysterious Mr. X—increase expenditures by $10. The immediate result of this increase in aggregate demand is that GNP and national income will rise by $10. That is, the individuals in this economy have received an additional $10 in income.

But the story doesn't end there. Of the additional $10 in income that they receive, the individuals in the economy will spend (.75) x ($10) = $7.50 on consumption goods. Hence, an additional $7.50 worth of goods will be produced; so, GNP and national income rise by another $7.50. And, of this increase in income they will spend (.75) x ($7.50) = $5.63 on

consumption goods. So far, the original $10 increase in aggregate demand has led to an increase of

$$\$10 + \$7.50 + \$5.63 = \$23.13$$

in GNP and national income; and the process continues: Of the $5.63 increase, the economy will spend $4.22 on consumption goods, increasing GNP and national income by another $4.22. Of the $4.22 increase, $3.17 will be spent on consumption goods....

The effect of the original increase in aggregate demand is being multiplied, since it set off a chain reaction. The original increase in expenditures (aggregate demand) led to an increase in national income which led, in turn, to an increase in consumption expenditures which further increased income and led to further increases in consumption expenditures. The process would continue, with the increase in GNP and national income getting smaller and smaller in each round. For the case we have illustrated, when the increase in income is finally zero, GNP has increased by $40:

$$\Delta GNP = \$10 + \$7.50 + \$5.63 + \$4.22 + \$3.17 + \ldots = \$40.00$$

That is, in this case, the multiplier is 4—a $10 increase in expenditures by the mysterious Mr. X led to an increase of (4) x ($10) = $40 in GNP and national income. The multiplier was 4 because we presumed that the individuals in the economy spent 75% of any increase in income. Had they spent less (more) than 75%, the multiplier would have been smaller (larger).[5]

In the Keynesian approach, the mysterious Mr. X is the federal government. If the government were to increase its expenditures by increasing its purchases of final goods and services or by paying transfer payments to individuals who would spend the money on final goods and services, income in the economy would increase by a multiple of the original expenditure by the government.

And, most significantly, the expected expansion in the economy would be the greatest if the government resorted to deficit spending. Since the size of the multiplier depends on the percent spent, an increase in taxes to finance the increased expenditures would drain off some of the expansion in spending and thereby reduce the size of the multiplier. The view of the Keynesian economists is that a deficit will lead to the largest expansion in income and employment.[6]

The assertion is that deficit spending can lead to an expansion in business activity—employment and income—if such a policy is implemented when the economy is experiencing a recession. Note, however, the caveat implied: Deficit spending may lead to growth in employment and income; *but* it will occur only if the economy is otherwise running below full employment.

However, if the economy is operating at or near full employment (if the economy is expanding), deficits can reduce or reverse the growth in the economy. Given our discussion to this point, it should be clear that this could occur as a result of the effect of deficits on inflation and the interest rate or it could be the result of so-called supply side constraints, a point we will turn to next. It is this concern that was voiced when we many economists worried that "the deficit would choke off the recovery in 1983-84." If deficits lead to higher interest rates, investment spending (as well as spending by consumers on housing and other durable goods) would decline and the growth of the economy would be slowed.

Hence, the relation between deficits and growth in the economy is one of those questions for which the answer is "it depends." If the economy is experiencing a recession, it well may be the case that deficit spending may increase aggregate demand and lead to increases in employment and income. However, if the economy is operating near full employment, the crowding-out that accompanies deficit spending can reduce the rate of growth of the economy.

Can a Deficit Retard Growth?

The work of John Maynard Keynes has been used as the rationale for substantial governmental presence in a free enterprise economy. However, the position of the economists known as "supply-siders" is that the use of his theory has gone well beyond the level intended by Keynes. Simply put, Keynes viewed investment by business in plant, equipment, and inventories as being extremely volatile. He proposed that when private investment declined, recessions would occur and that government spending could replace private investment spending in reestablishing full employment. In the economy Keynes envisioned, government spending was as acceptable as private spending. The supply-siders argue that this is not the case.

The position of the supply-siders is that continual and increasing government deficits reduce the incentives for private businesses and individuals to produce and invest. Increasing government expenditures require increasing taxes and may lead to excessive money creation. Hence, the supply-siders argue that the expansionary effect of deficit spending will be diminished since it will result in diminished spending by the private sector and—most importantly—can result in lower productivity.

In a very simplified form, the argument of the supply-siders can be presented as follows: As government increases its share of the economy (i.e., as government expenditures as a percent of GNP rise), taxes will eventually rise. Higher tax rates discourage work and investment; so, the rate of growth of the economy would be less than would be the case if government's share was smaller.[7] Furthermore, higher tax rates induce people to seek tax havens; the investments made are different than those that would be made at lower tax rates. Resources are devoted to reducing taxes rather than in producing additional output. The upshot is that productivity declines. Investments are made that produce less growth in output that could be obtained in the absence of the high taxes, and individuals work less than they would otherwise.

Notwithstanding the impact on productivity, it is the effect of deficits and the subsequent tax increases on saving and investment that supply-side economists view as the most harmful. Savings are extremely important, since savings provide the pool of loanable funds for investment which, in turn, leads to increased growth in the economy. In the extreme case, if there exist high tax rates and inflation—as might be the case with continuing increases in government spending—individuals may be induced to dissave (i.e., borrow rather than save). That is, it would make sense to borrow for consumption expenditures. In this instance, the economy would shrink rather than grow.

Supply-siders contend that, because of the effects noted above, real output of goods and services has lagged behind increases in nominal incomes. That is, individuals and firms are producing less physical output for each dollar received than they did in the past. The result is that inflation can occur even in periods of less than full employment. According to the supply-siders, the stagflation this economy has experienced may be the result of the growth in government's share of GNP and the attendant structural deficits we have seen since the 1960's. Hence, the position of the supply-side economists is that deficits—structural deficits—could retard growth and could even lead to negative growth.

Is a Balanced Budget Amendment The Wonder Drug for the 80's?

In the simplest form, a balanced budget amendment could be viewed as a device that forces the government to insure that expenditures and revenues are equal. While this approach has some appeal, this simple solution is not a panacea. In essence, this simple form of a balanced budget would require that increases in government spending always be financed by increased taxes. However, as we have seen, increases in taxes can crowd out investment, as would borrowing or increases in the money supply. Furthermore, there are many who

would argue that deficits are essential during periods of prolonged recession and that this simple approach to a balanced budget rules out desirable policy actions.

Our position is that discussions of the deficit hide the real problem. In our opinion the problem is not the size of the deficit or the manner in which it is financed. The problem is the size of government expenditures. More specifically, the problem is the size of the government expenditures as a percent of GNP. In Exhibit 7, we have provided a graph showing the historical path of government expenditures as a percent of GNP.

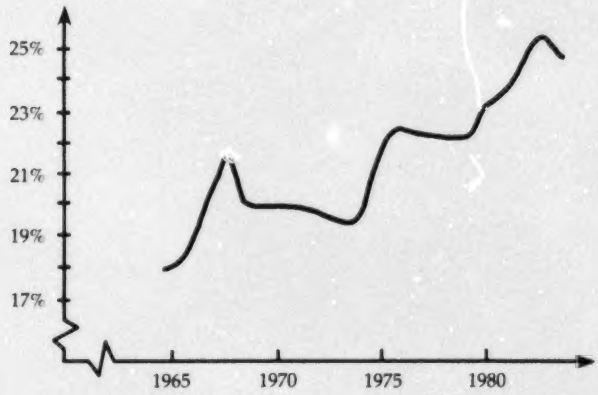

Exhibit 7
Government Expenditures as a Percent of GNP

While a balanced budget amendment is neither a panacea nor a wonder drug for the 80's, it may indeed be the medicine that is called for to cure the ills that currently plague the American economy. The major feature of such an amendment is that legislators will have to consider expenditures and revenues simultaneously. That is, if congress wishes to spend additional moneys, it must at the same time find the money necessary to finance these additional expenditures. In itself, this would be a major departure from the current system in which the budget is debated long and hard at the beginning of a session and then essentially ignored as spending bills are considered. A balanced budget amendment would require that the budget actually mean something. With such an amendment, budgetary limitations would have to be constantly considered and the federal budget would look more like a true budget that you and I deal with in our own lives.

ASIDE—Fiscal Responsibility is Not a New Idea

It seems as though budget deficits are almost a normal state of affairs. In fact, however, chronic deficits are relatively new to the American economy. It was only since the 1960's that budget deficits have become a way of life. Prior to the 60's, a balanced budget was the more normal experience, with deficits occurring during periods of war or severe recessions.

As pointed out by Richard E. Wagner and Robert D. Tollison in *Balanced Budgets, Fiscal Responsiblity and the Constitution*, a call for fiscal responsibility is not a new idea. In 1896, Knut Wicksell elaborated the basic principles for budgetary decision-making and set out constitutional rules for implementing these principles. Foremost among these was the idea that proposals for expenditures must be coupled with proposals for covering the cost. If a legislator could propose expenditures without having to propose simultaneously the way they are to be funded, fiscal irresponsibilty will creep in because the legislator can promise benefits without having to explain who will finally pay the cost. As Wicksell noted, a rule that requires open recognition of the two-sided nature of government budgets promotes fiscal responsibility.

Footnotes

[1]"How to Cut the Deficit" (Special Report) *Business Week*, March 26,1984, pp. 49-106. The opening quotation from Adam Smith also appeared in this article.

[2]In the United States, we employ a fractional reserve system. This means that banks are required to hold reserves equal only to a percentage of their outstanding demand deposits. Hence, banks are permitted to loan out a multiple of their excess reserves. Therefore, when the Fed increases reserves, the money supply can expand by a multiple of the increase in reserves. The upshot is that the increase in the money supply can be far in excess of the original size of the monetized deficit.

[3]See "Is Inflation a Consequence of Government Deficits?" in *Economic Review*, the Federal Reserve Bank of Atlanta, August 1982, pp. 25-32.

[4]See Friedman and Heller, *Monetary vs. Fiscal Policy*. New York: W. W. Norton & Co., 1969, pg. 50.

[5]More specifically, if we define the additional spending (consumption) that results from the increase in income as the marginal propensity to consume (MPC), the multiplier is 1/(1 − MPC).

[6]In terms of the multiplier with a deficit, the multiplier would be the largest when the debt is monetized, somewhat less if the deficit is financed by borrowing from commercial banks, and still less if it is financed by borrowing from private firms and individuals. The smallest multiplier would result in the case in which increases in government expenditures were financed by a corresponding increase in taxes.

[7]An increase in the tax rate has the effect of reducing the after-tax wage rate or the after-tax rate of return from an investment. If the (after-tax) wage fails, individuals supply less labor. Likewise, if the (after-tax) rate of return falls, fewer investment projects will be undertaken.

References and Suggestions For Additional Reading

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